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Supreme Court of the United States

OCTOBER TERM, 1925.

No. 265.

KANSAS CITY TERMINAL RAILWAY COMPANY et al.,
Appellants,

vs.

CENTRAL UNION TRUST COMPANY OF NEW YORK
Trustee, et al.,
Appellees.

On Certificate from the Circuit Court of Appeals for the Eighth Circuit.

BRIEF FOR CENTRAL UNION TRUST COMPANY OF NEW YORK ET AL.

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STATEMENT.

The United States Circuit Court of Appeals for the Eighth Circuit, by an order dated January 22, 1925, certified to this Court three questions or propositions of law under Section 239 of the Judicial Code, concerning which it desired the instruction of this Court for their proper decision.

Included in the certificate was a statement of the nature of the cause and of the facts on which such questions or propositions arose.

Thereafter the Kansas City Terminal Railway Company and others, appellants, filed in this court a petition for writ of certiorari directed to said United States Circuit Court of Appeals for the Eighth Circuit, commanding said court to certify and send to this Court a full and complete transcript of the record of the proceedings in said Circuit Court of Appeals in the cause, "to the end that this Court may decide the whole matter in controversy in the same manner as if it had been brought to this Court for review by writ of error or appeal—all as provided in Section 239 of the Judicial Code and Rule 37 of the rules of this Court," and a brief in support thereof.

The Circuit Court of Appeals for the Eighth Circuit on April 25, 1925, filed an **amended certificate "in lieu** of the certificate heretofore filed in order that certain additional facts (deemed by the parties and this Court of use in determining the questions herein submitted) might be brought to the attention of the Court." In the **amended certificate** the **questions certified** were **exactly the same** as those certified in the original certificate, the difference between the original certificate and the amended certificate being **in the statement of the nature of the cause and of the facts under which the questions or propositions of law arose.** Said amended certificate reads as follows:

> "This amended certificate is presented, **in lieu of the certificate** heretofore filed, in order that certain

additional facts (deemed by the parties and this Court of use in determining the questions herein submitted) might be brought to the attention of the Court.

"The United States Circuit Court of Appeals for the Eighth Circuit hereby certifies that a record on an appeal now pending before it discloses the following:

"The Kansas City Terminal Railway Company and others filed an intervening petition in the receivership proceedings of the Missouri, Kansas & Texas Railway Company. That intervention sought to attach the obligations of passenger terminal contracts to the property in such a way that the obligations of these contracts would be either a lien on the property prior to all mortgage obligations, or would follow the property into the hands of any purchaser under foreclosure of the mortgages. It was determined by the District Court and affirmed by this Court (294 Fed. 32) that these terminal contracts were ordinary executory contracts entered into by the Missouri, Kansas & Texas Railway Company as aids to its operation.

"Thereafter, the property in receivership was sold under foreclosure. The purchase was in pursuance of a reorganization plan. This plan involved lienholders, unsecured creditors and stockholders. In so far as the plan affects lienholders it is not involved in this appeal. The points raised on this appeal relate to the **fairness of the offer to these interveners**, which were classed as **unsecured creditors. This plan was not submitted to the Court, but the offer to unsecured creditors, as contained therein, was submitted and approved. Their claim is that the stockholders were unduly preferred in this reorganization plan.**

"By the reorganization plan the new company was to have four classes of securities, as follows:

"Prior lien mortgage bonds (authorized issue $250,000,000).

"Cumulative adjustment mortgage bonds (authorized issue $100,000,000), which were **income bonds** secured by mortgage as to principal; preferred stock (authorized issue $200,000,000).

"Common stock without par value (authorized issue 2,500,000 shares).

"Of the above securities, certain amounts of each were reserved for future use by the new company. Of the prior lien bonds provided for distribution in the plan, some bore interest at 4 per cent, some at 5 per cent and some at 6 per cent, respectively.

"Under the reorganization plan new securities were offered to the holders of **seventeen separate issues** of outstanding **bonds** of the Missouri, Kansas & Texas Railway Company, and its various subsidiary companies secured by mortgage, and of **one issue of notes** secured by the pledge of mortgage bonds. In some cases, but not in all, cash was offered to the holders of these secured claims in addition to new securities. **In all cases** the par amount of the new securities offered (taking the new non par value common stock at $100 per share), plus the cash offered, if any, **equaled, and in no case did it exceed,** the principal amount of the old outstanding securities in respect of which the offer was made, **plus the unpaid interest thereon up to January 1, 1922.**

"Of said eighteen outstanding issues:

"Five issues were offered only new prior lien bonds and cash.

"One issue was offered only new prior lien bonds.

"Five issues were offered only new prior lien bonds and new adjustment bonds.

"Three issues were offered only new prior lien bonds, new adjustment bonds and **new preferred stock.**

"**One issue** was offered **only new adjustment bonds** and **new preferred stock.**

"**Three issues** were offered only new **adjustment bonds, new preferred stock** and **new common stock.**

"In all cases, the new prior lien bonds and the new adjustment bonds (whether offered to secured creditors, unsecured creditors or stockholders) **were to bear interest from January 1, 1922.**

"In so far as the reorganization plan affected **stockholders and unsecured creditors,** its provisions were substantially as follows: (1) Preferred stockholders were entitled to receive $14 in prior lien bonds (bearing 6 per cent interest), $6 in adjustment bonds and one share of common stock in the new company upon payment of $20 for each share of stock of the par value of $100 held in the old company. (2) Common stockholders were entitled to receive $17.50 in prior lien mortgage bonds (bearing 6 per cent interest), $7.50 in adjustment bonds and one share of common stock upon payment of $25 for each share of stock of the par value of $100 held in the old company. (3) Unsecured creditors were given the choice of two plans: (a) One-third of a share of preferred stock of the par value of $100 and two-thirds of a share of common stock without par value for each $100 of the aggregate amount of the claim, including interest to January 1, 1922, whereas the Receiver was appointed and took possession of the property on September 27, 1915, the foreclosure decree was entered on June 30, 1922; the offer to creditors was dated July 15, 1922;

the foreclosure sale was had on December 13, 1922; the order confirming the sale was entered February 9, 1923, and the order approving the Master's deed conveying the property to the new company was entered on March 10, 1923. (b) Fourteen dollars in prior lien mortgage 6 per cent bonds, $6 in adjustment mortgage bonds and one share of common stock upon payment of $18 for each $100 of said claim.

"**A claim made by appellants here is that** certain decisions of the Supreme Court of the United States (Northern Pacific Railway Company v. Boyd, 228 U. S. 482; Louisville Trust Company v. Louisville Railway Company, 174 U. S. 674) **require** that **an offer** in a reorganization plan, in order to **be a fair** and binding offer upon the creditor **must be one which will preserve** 'to the creditor his **relative priority over the stockholders.** It is **not sufficient that he should get a little more than the stockholder.** His **entire claim must** take **precedence** over **any part** of the interest of **a stockholder.** It is **not sufficient** that he be offered securities of the **same grade** as the **stockholder,** but a **trifle more in amount,** or that the **stockholder's right to participate be conditioned upon the payment of an assessment.'**

"It is further certified that the **following questions of law** arise from this record and are presented, the decision of which is indispensable to a determination of the case. To the end that this Court may properly discharge its duty, it desires the instruction of the Supreme Court upon them.

"Question I. Is a plan of reorganization of a railway company sufficient as to unsecured creditors and binding upon them which does not give precedence to the entire claim of the creditor over any part or interest of a stockholder in the old company?

"Question II. Is such a plan fair and binding upon such creditors even though they be offered securities of the same grade as the stockholders, the difference being only in the greater amount offered the creditor, provided the Court shall be of the opinion that the offer tenders to such creditor all that could reasonably be expected under all of the existing circumstances?

"Question III. Is such offer as to such creditors fair and binding if it consists **only** of the same grade of securities as offered the stockholders, the difference being that the right of the stockholder to participate is conditioned upon the payment of **an assessment**, or the payment of a relatively greater assessment, than that asked of such creditors, provided the Court shall be of the opinion that the offer tenders to such creditor all that could reasonably be expected under all of the existing circumstances?"

Thereafter this Court, on May 4, 1925, denied appellants' petition for writ of certiorari to bring up the whole record and cause (45 Sup. Ct. Rep. 512).

Counsel for appellants, since filing their brief, have written us that their statement that their motion was still pending was made in ignorance of the fact it had been denied.

This Court had previously (in 264 U. S. 588) denied appellants' petition for writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit in the first appeal of Kansas City Terminal Railway Company referred to in the certificate (294 Fed. 32), wherein that Court held (as stated in the certificate) that the contracts sued upon did not constitute a lien on the property prior to all mortgage obligations and did not follow the property into the hands of the appellee purchasing com-

pany—Missouri-Kansas-Texas Railroad Company—and that they were nothing but ordinary executory contracts.

The earlier appeal of appellants is hereinafter for convenience called the first appeal.

The sole controversy in the present or second appeal is whether the offer made by the Reorganization Managers to unsecured creditors of the old company was a fair and reasonable offer. As stated in the certificate, the claim was made by appellants in the court below that "certain decisions of the Supreme Court of the United States (Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482; Louisville Trust Co. v. Louisville Ry. Co., 174 U. S. 674) require that an offer in a reorganization plan, in order to be a fair and binding offer upon the creditor, must be one which will preserve 'to the creditor his **relative priority over the stockholder.** It is not sufficient that he should **get a little more than the stockholder.** His **entire claim** must **take precedence** over any part of the interest of a stockholder. It is not sufficient that he be offered **securities of the same grade** as the stockholder **but a trifle more in amount**, or that the **stockholder's right** to participate be conditioned upon the **payment of an assessment.**'" It was on account of these claims of appellants that the Circuit Court of Appeals certified to this court the three questions now before it.

Questions I and II, certified by the Circuit Court of Appeals, refer to the first of the two alternative offers to creditors under which creditors were entitled to receive, for each $100 of their claims, including interest to January 1, 1922, one-third of a share of preferred stock of the New

Company (par value $100) and two-thirds of a share of common stock without par value. This offer is hereinafter referred to as offer A. Question I is presumably based on the fact that creditors were offered one-third in preferred stock and two-thirds in common stock for their claims. The word "precedence" in this question must be taken to mean precedence in rank of securities, since it is admitted that "the entire claim of the creditor" was given precedence in value of securities and no stockholders received any preferred stock. Question II is apparently based on the fact that the creditors received proportionately more securities in amount than the stockholders (or indeed than bondholders), since they received securities in respect not only of principal, but also of interest after the receivership. Hence it is clear that the general creditor is preferred over both the old preferred and common stockholders. The preference applies to the whole of the general creditor's claim and not simply to one-third thereof as contended by appellants. The point of law raised by these questions is the same, viz., whether the test of a "fair and reasonable" offer is the comparative **value** of the securities offered to creditors and stockholders in a reorganization, or the relative **rank** of such securities in the corporate structure of the corporation resulting from the reorganization. It should be noted, however, that if question I is answered in the affirmative, the answer to question II is immaterial for this case.

Question III asks whether an offer to creditors may be "fair and reasonable" if creditors are offered securities

of the same grade as stockholders, both classes being required to pay by way of assessments for the securities they receive, the creditors, however, paying less than the stockholders. This refers to the alternative offer to creditors, giving them the option to purchase the same securities which the stockholders took, but for less money. This offer is hereinafter called offer "B." The creditor, therefore, had a choice of two offers. If he considered the offer to stockholders better than offer A to the creditors he could, at his election, accept offer B on better terms than the stockholders.

It is clear from the foregoing analysis of the questions certified by the Circuit Court of Appeals that only one substantial question of law is involved, namely, whether the test of a fair and reasonable offer is the value of the securities offered or their character. The subsidiary point raised by question III is only discussed briefly in view of the alternative offer made.

The question of the **actual** fairness of the offer, as distinguished from the **legal** fairness, i. e., whether, on the facts of this case, the new securities issuable in the reorganization were so distributed as to recognize equitably the respective interests of secured creditors, unsecured creditors and stockholders, is not before this Court. The questions certified by the Circuit Court of Appeals are stated to be based on the assumption that the offer "tenders to such creditor all that could reasonably be expected under all of the existing circumstances," that is that the offer was fair and reasonable, on fact.

SUMMARY OF THE ARGUMENT.

In its certified questions the court below has indicated its opinion that the offer tendered to creditors is all that could reasonably be expected in the circumstances. The question is, therefore, whether that offer, in itself fair and reasonable, must in this court be held to fail for not conforming to some fixed formula. The virtue of a formula is alleged to be that it will relieve chancellors, faced with intricate facts and complex financial questions in reorganization cases, of the difficult duty of deciding whether in the circumstances of practical affairs, offers are fair and reasonable. In the rigidity of the formula, appellants say, the unsecured creditor is to find the certain fairness of his treatment. What the formula is to be, they do not make clear. Apparently it is that everything given creditors must outrank anything given stockholders, and that creditors in these ranking securities must receive their whole claims, principal and interest. On appellants' theory of formula they find no merit in the value granted creditors exceeding that allowed to stockholders. Yet the need of the creditor is to realize his debt. But the maturity of income bonds usually is long. Nor have preferred stocks term at all. It is fanciful to suppose a creditor waiting the twenty or one hundred years to maturity to enjoy his income bond's priority of principal or awaiting the perpetuity mentioned in his company's charter as the term of its existence, to enjoy in distribution the priority of his preferred over the com-

mon stock. Nor is he likely, if he can help it, to linger even until sooner failure of the new enterprise shall have afforded earlier opportunity to assert his priority or preference over the common stock. To realize whatever he may hold, whether bond or preferred stock, the market must be his resort. But in the market price is what he seeks. Prior or preferred though his income bond or stock may be, it helps him little if because of low rate of return or for other reason it brings him less than he would have got for common stock. Value, therefore, and not rank, of his security is the essential. Nor is it material whether his superiority in value be achieved by giving to him ratably more stock of the same rank than is given stockholders or ratably the same amount for a less assessment.

But assuming it were a benefit to the creditor to be assured a priority or preference accorded by a formula, rather than a solid market value under an offer which the Chancellor, who knows the case, shall have declared fair and reasonable, there remains the question how property is to be put behind the income bonds or preferred stock which the formula requires. If an unsecured creditor must have, in securities outranking anything given stockholders, a par amount equal to his debt with interest, is the secured creditor to fare worse as against the unsecured than the unsecured against a stockholder? Yet if the secured creditor is to have a prior lien for his whole debt and interest before an unsecured creditor gets anything, how can there in the usual case be any value to

support bonds or preferred stock for the unsecured creditor as required by the formula? In railroad reorganizations, new securities, since the Transportation Act, can be issued only with the assent of the Interstate Commerce Commission. It has been loath, and rightly so, to permit mortgage bonds or preferred stock to be issued beyond the value of the property or even for its full value. In consequence, unless mortgage creditors have been unfairly dealt with, there often does not remain value of property sufficient to support for unsecured creditors a par value of preferred securities to satisfy the formula. The solution may often have to be to give to unsecured creditors preferred stock if and to the extent it may be available and in addition to give to them and to stockholders who supply new money by taking bonds at a high price, common stock without par value representing hope of the new company's growing prosperity, in which unsecured creditors shall receive a greater ratable share than stockholders.

Appellants sacrifice accuracy for the sake of symmetry of their argument when they assert that the **Boyd** case merely mitigates for railroads and other public utilities a general rule that in reorganizations creditors must be paid in full in cash before stockholders may receive anything. Neither the language of the **Boyd** case nor of the other cases which deal with the doctrine of that case, nor general equitable principles, support the assertion.

The suggestion of appellants can scarcely be serious that it is necessary to substitute a formula for the judicial,

equitable discretion of the Chancellor as to whether a reorganization offer is fair, in order to prevent fairness from degenerating into a mere phrase to be applied according to the individual whim of the Chancellor. Formulas which shall render unnecessary wisdom, knowledge and consciences in Judges have been will-o'-the-wisps of the law, followed only too often in vain and to destruction. Considerations which have led courts for centuries to decline pleas to reduce to a formula the definition of fraud are as valid against making a formula for fairness. The "fixed rule" of the **Boyd** case, that creditors must be better treated than stockholders, courts can administer. But a formula defining in advance for all reorganizations, of all properties, in all conditions, what such treatment must be, they could not. For reorganizations can never be alike. It would be a miracle of coincidence if in any two the value of the failed company's property, its debts, the amount, rank and relative proportion of liens, the money market at the time of reorganization, amount of new money required, and other decisive circumstances were identical. For these reasons each of the questions certified should be answered in the affirmative.

ARGUMENT.

POINT I.

The test of a fair and reasonable offer under the doctrine of the Boyd case is whether the value of the offer made to creditors adequately represents, in the light of all the facts in the case, their proportionate interest in the reorganized property. The character of the securities offered to creditors is immaterial.

(a) **The decided cases are in harmony with this view.**

The contention of the appellants in the Circuit Court of Appeals and in the District Court was, primarily, as stated in the certificate of the Circuit Court of Appeals, that the offer made to creditors was not fair and reasonable, irrespective of the comparative value of the securities offered to creditors and stockholders, because all the securities offered to creditors were not prior in rank to all securities offered to stockholders.

It is clear that all contentions of the appellants have been decided adversely to them by the Circuit Court of Appeals, except the contention based on a suggestion or dictum of this Court in the **Boyd** case, which has been referred to this Court by the Circuit Court of Appeals for determination.

This Court has had before it but three cases, so far as we are advised, involving the rights of unsecured cred-

itors in the reorganization of a corporation by foreclosure and sale. These were

Louisville Trust Company v. Louisville etc. Ry., 174 U. S. 674 (Monon case), decided in 1899;

Northern Pacific Railway v. Boyd, 228 U. S. 482 (Boyd case), decided in 1913, and

Kansas City Southern Ry. Co. v. Guardian Trust Company, 240 U. S. 166 (Guardian Trust case), decided in 1916.

The case of **Pierce v. United States**, 255 U. S. 398, on which the appellants rely, had to do with the enforcement of a judgment obtained by the United States against stockholders to whom the debtor corporation had distributed its property without consideration. No offer to creditors was in any way involved.

The **Monon case**, the **Boyd case** and the **Guardian Trust Company case**, as well as many others, hold that reorganizations carried out by agreements between between bondholders and stockholders are entirely proper, and in most cases essential to substantial justice to all, if stockholders thereby do not secure for themselves an interest in the reorganized property to which unsecured creditors are equitably entitled (Fosdick v. Schall, 99 U. S. 235; Canada Southern Ry. Co. v. Gebhard, 109 U. S. 527; Central Trust Company v. U. S. Rolling Stock Co., 56 Fed. 5; Guaranty Trust Co. v. Missouri Pacific Ry. Co., 238 Fed. 812; Lane v. Equitable Trust Co., 262 Fed. 918 [being same Wabash reorganization before Supreme Court of Michigan

in case of Marshall v. Wabash Railroad, cited by opposing counsel]; St. Louis & San Francisco Ry. Co. v. McElvain, 253 Fed. 123).

This Court never questioned that bondholders are entitled to foreclose their mortgages, and to take to themselves the entire property subject thereto, if such property could not be sold for more than enough to satisfy the mortgage, excluding both unsecured creditors and stockholders. It has held, also, that stockholders may retain an interest if not done at the expense of creditors, and that, if creditors are fairly provided for, they cannot complain.

In none of the cases before this Court had any offer of participation been made to creditors, so that this Court has never had occasion to decide how such an offer must be made, or of what it must consist. Obviously, no general rule can be laid down, since the fairness of an offer to creditors must depend on the facts of each particular case, including the value of the property involved, i. e., to what extent creditors have any interests to be protected, after satisfaction of the secured debt (see discussion in **Guardian Trust Co.** case, referred to at p. 43, infra) and the relative participation of bondholders, creditors and stockholders. This is more fully discussed under point II, infra, p. 35. In the **Boyd** case, however, this Court, although no offer was before it, answered an objection made by counsel for the defendant railway company, that the rule laid down by this Court would require the pay-

ment of unsecured creditors in full, and in cash, and prevent reorganizations, by saying (at page 508):

> "This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. **His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock.**" (Boldface type ours.)

It should be noted that, even if the bold-face type language were a decision of this Court, instead of a suggestion, it would not sustain the contention of the appellants. It does not say, or even imply, that creditors must receive securities of a higher rank than stockholders, **for in the reorganization under consideration in the Boyd case preferred stockholders of the old company received preferred stock in the new company.** (See 228 U. S. 482 at page 489.) It simply means that creditors must receive, in lieu of cash, a fair offer in securities having a real value. To sustain appellants' claim they contend, not only that the suggestion or dictum in the Boyd case was a binding general rule laid down by this Court, but also that it means that in every case, irrespective of the value of the property and of the character or value of securities received by bondholders and stockholders, creditors must receive "income bonds or preferred stock." The logical difficulties which this contention involves will be discussed under (b) below (p. 26).

It must be repeated again that no offer to creditors was before the Court in the **Boyd** case, and that the expression above quoted was merely a suggestion or dictum. This Court has said:

> "It is a maxim not to be disregarded that general expressions in every opinion are to be taken in connection with the case in which those expressions are used. If they go beyond the case they may be respected, but ought not to control the judgment in a subsequent suit when the very point is presented for decision" (Cohens v. Virginia, 6 Wheat. 264, l. c. 398).

Since this Court has never had a specific offer to creditors before it, it has never had occasion to apply to specific cases the principles enunciated in the cases above referred to. The District and Circuit Courts have, however, frequently done so. The Circuit Court of Appeals for the Eighth Circuit, in **Western Union Telegraph Company v. United States and Mexican Trust Company**, 221 Fed. 545, at p. 549, said:

> "Any plan or scheme threatened or executed whereby the holders of the bonds secured by the mortgage and the stockholders secured, or intend or undertake to secure, to the stockholders, by contract, foreclosure sale, or other device, an equal or a greater benefit from the property than is thereby secured to, or offered to and rejected by, the general creditors, is such a breach or threatened breach of trust as entitles any complaining creditor to relief in a court of equity. A purchase through a foreclosure sale, or

otherwise, of the property of an insolvent corporation by a new corporation, pursuant to a plan or scheme of the bondholders and stockholders of the insolvent company, whereby the stockholders thereof derive, by receipt of stock or bonds of the new company, or otherwise, **benefits equal to or greater than** those received by, or openly offered to and rejected by, its general creditors, is fraudulent in law as to the latter, and renders the new corporation and the property it purchased at such sale liable for the claims of such creditors against the old company, at least to the extent of the value of the interest secured by the stockholders of the old company in excess of the value of the interest secured by, or openly offered to and rejected by, the unsecured creditors (Northern Pacific Ry. Co. v. Boyd, 177 Fed. 804, 101 C. C. A. 18; Northern Pacific Ry. Co. v. Boyd, 228 U. S. 482, 502, 504, 33 Sup. Ct. 554, 57 L. Ed. 931; Louisville Trust Co. v. Louisville etc. Ry. Co., 174 U. S. 674, 683, 684, 19 Sup. Ct. 827, 43 L. Ed. 1130; Central Improvement Co. v. Cambria Steel Co., 210 Fed. 696, 701, 702, 127 C. C. A. 184, 189, 190." (Bold-face type ours.)

And the same Court in **Phipps v. C. R. I. & P. Ry. Co.**, 284 Fed. 945, said:

"In support of this contention they cite and the Court has examined Kansas City Southern R. Co. v. Guardian Trust Co. et al., 240 U. S. 166, 36 Sup. Ct. 334, 60 L. Ed. 579; Northern Pacific R. Co. v. Boyd, 228 U. S. 482, 33 Sup. Ct. 554, 57 L. Ed. 931; Texas & Pacific Ry. Co. v. Bloom, 164 U. S. 636, 17 Sup. Ct. 216, 41 L. Ed. 580; Texas & Pacific Ry. Co. v. Johnson, 151 U. S. 81, 14 Sup. Ct. 250, 38 L. Ed. 81; South-

ern Pacific Ry. Co. v. Bogert, 250 U. S. 483, 39 Supt. Ct. 533, 63 L. Ed. 1099. But the opinions and decisions in those cases do not consider or rule the question in this case, because in none of them had the Court, in the decree assailed, considered, adjudged, secured or offered to the complainant his or its fair and just share of the property of the insolvent corporation it was administering and distributing, while in the case in hand the courts by their decrees carefully adjudged, secured, and still secure to Mr. Phipps his equitable share of the property which the Court administered and distributed.

"The vice which rendered the foreclosure, judicial sale and delivery of the property to the reorganized corporation voidable by unsecured creditors in the Boyd case, 177 Fed. 804, 101 C. C. A. 18, Id., 228 U. S. 482, 502, 504, 33 Sup. Ct. 554, 57 L. Ed. 931, and in the Kansas City Southern Ry. Co. case, 240 U. S. 166, 36 Sup. Ct. 334, 60 L. Ed. 579, was not the lack of judicial sales of the property under the decrees, but the fact that under the plans of reorganization and by the decrees in those cases the stockholders of the insolvent corporations were given for their stock beneficial interests in the reorganized companies by the way of stocks, bonds, or other securities, while the unsecured creditors of the insolvent companies were given nothing. That vice does not inhere in the plan of reorganization or in the decrees in the case at bar. That plan and those decrees secured to Mr. Phipps and to the other unsecured creditors, beneficial interests in the reorganized company **of much greater proportionate value** than those thereby secured to the stockholders of the insolvent company."

* * * * * * * *

"An analogous question arose in the foreclosure of mortgages upon the property of railroad companies after the Supreme Court had held in the Boyd case and the Kansas City Southern Railway Company case that judicial sales under decrees of foreclosure of such mortgages pursuant to the plans of reorganization which did not assure to unsecured creditors interests in the property of the reorganized corporations **more beneficial proportionately** than those secured to the stockholders were voidable by such creditors." (Bold-face type throughout ours.)

In **Mountain States Power Co. v. A. L. Jordan Lumber Co.**, 293 Fed. 502, the Circuit Court of Appeals for the Ninth Circuit said:

"The next question is, was adequate and equitable provision made to preserve the interest of the lumber company under the reorganization? There was no offer or tender of income bonds or preferred stock, as suggested in the Northern Pacific case (**Boyd** case). Of course, the method there suggested is not exclusive * * *"

and then went on to hold, that, in the light of the facts as to the value of the property involved, the offer under consideration was not a fair and reasonable one.

See also **Howard v. Maxwell Motor Company**, 269 Fed. 292 (affirmed 275 Fed. 53, by Court of Appeals for Second Circuit), in which an offer to creditors consisting of preferred and common stock, as in the case at bar, was approved.

See also **P. R. Walsh Tie & Timber Co. v. Missouri Pa-**

cific Railway Company, 280 Fed. 38 (Circuit Court of Appeals for Eighth Circuit).

The opinion of the trial court (Judge Sanborn, senior Circuit Judge), approving the offer to unsecured creditors, in the case at bar, reads as follows:

> "This Court has said and written so much in the last six years concerning the relative rights and remedies of the stockholders and unsecured creditors of an insolvent railroad company under a plan of reorganization of such company similar to that under consideration in this case, and concerning the fairness, justice and timeliness of offers to unsecured creditors in the benefits of such reorganized corporations through stock, bonds or otherwise, that it would be useless in this case to do more than to say that the reasons for the conclusion the Court now has reached in this case are stated in its oral opinion delivered in this court about August 13, 1916, in North American Company v. St. Louis & San Francisco Railroad Company, No. 4174, Consolidated Cause, final; in its opinion in Guaranty Trust Company v. Missouri Pacific Railway Company, 238 Fed. 812 and in its opinion in St. Louis-San Francisco Railway Company v. McElvain, 253 Fed. 123, and in the opinions of the Circuit Court of Appeals of this circuit in Phipps et al. v. Chicago, Rock Island & Pacific Ry. Co., filed October 9, 1922, and in P. R. Walsh Tie & Timber Company v. Missouri Pacific Railway Company, 280 Fed. 38, 42-44.
>
> "In comparing the offer in this case with those made in the cases cited, this radical difference in the basis of the offer should not be overlooked. The evidence in this case is that the value of an unsecured

claim of $1,000 against the old insolvent company, based on the present market value of the stock offered to the owner of such a claim pursuant to the decree, is about $235.84, or about 23.6 per cent of the amount of the claim. But the amount of the claim of which this offer is 23.6 per cent is the amount of the face of the claim in September, 1915, when this Court took possession of the property of the insolvent company by its Receiver, plus interest on that amount at 6 per cent per annum from that time to January 1, 1922. The interest during this time, at 6 per cent per annum, amounts to above 43 per cent of the amount of the claim in September, 1915, so that while the market value of the securities offered an unsecured creditor is about 23.6 per cent of the amount of his claim in April, 1916, plus interest on that claim at 6 per cent from April, 1916, to January 1, 1922, its market value is more than 31 per cent of the amount of the claim in September, 1915, when the Court took possession of the property.

"When a court appoints a receiver and takes possession of the property of an insolvent corporation to operate it and distribute it or its proceeds to its creditors and stockholders it holds it in trust subject to prior liens for the unsecured creditors and stockholders at that time. Stockholders ordinarily receive no dividends during a receivership, and the established rule of practice and convenience is to allow the claims of unsecured creditors at their face value plus interest to the date of the appointment of the receiver, and not later. The amounts of the claims of the unsecured creditors in the St. Louis & San Francisco Railroad reorganization and in the Missouri Pacific Railroad reorganization were fixed and allowed and the securities of the new companies

were distributed to them upon that basis, and it is probable that this was the basis used in the reorganization of the Chicago, Rock Island & Pacific Railroad Company.

"When this fact is taken into consideration, together with all the other facts proved in this case and the facts disclosed in the opinions in the cases cited, the offer to the unsecured creditors in this case in comparison with the offer to the stockholders is much more favorable to the former than were the offers made to the unsecured creditors in the cases cited. And, upon consideration of all the facts and arguments in this case, and for the reasons stated in the opinions in the cases cited, the Court has concluded that the offer to the unsecured creditors in this case is fair, just, equitable and timely, and that it should be approved" (Tr. of Rec., p. 493).

The opinion of Judge Sanborn in **North American Company v. St. Louis & San Francisco Railroad Company**, referred to in the above opinion is, for convenience of this Court, printed as Appendix A to this brief.

We know of no case, either in the federal or state courts, in which an offer to creditors has been held unfair because of the **character** or **relative rank** of securities offered creditors or stockholders. The appellants cite **Wabash Railway Co. v. Marshall**, 224 Mich. 593, 195 N. W. 134 (Supreme Court of Michigan, 1923), as an authority in their favor. In this case, however, the Court allowed the creditor to recover against the reorganized company, not because the offer to creditors consisted of preferred and common stock, but because (a) the stock

had not been authorized by the Michigan Railroad Commission and (b) the offer was insufficient in amount in view of the value of the property.

In every decided case fairness or unfairness has been determined on the basis of the **relative value** of the securities offered, and in consideration of the value of the property involved and all other pertinent facts. This, we submit, is the only true test.

(b) **There is no logical basis for the contention that the character of the securities offered to creditors is the test of a fair offer.**

The test established by the decided cases above referred to is the only logical test of a fair offer to creditors. Obviously, in a reorganization, bondholders, unsecured creditors and stockholders desire to get back, as nearly as possible, the amount of their investment. They are interested in their relative rank in the new company resulting from the reorganization only to the extent that a higher rank represents greater value. And this is preeminently true of an unsecured creditor, who is an involuntary investor. The unsecured creditor does not care whether he receives preferred stock or common stock, so long as the value of what he receives is the same. If the appellants in this case were asked whether they would prefer to receive cash in full, or preferred stock to a par amount equal to their claims, can anyone doubt they would choose the cash? In other words, the attempt of the appellants to insist on an offer of preferred stock or income bonds is

merely an attempt to secure a greater amount for their claims in money or its equivalent—an attempt to review, under guise of a claimed principle of law, the finding of the District Court, in which the Circuit Court of Appeals apparently concurs, that they have been offered all that could reasonably be expected under the existing circumstances.

The true principle of the **Boyd** case is that, to the extent that the fair value of the mortgaged property exceeds the secured debt, unsecured creditors must be offered a right to participate in such excess ahead of stockholders by making them an offer of participation of a fair **comparative value.** Any other principle overlooks the substance of the situation and deals only with technicalities.

The application of the principle contended for by the appellants would in this case and in other reorganization cases produce absurd results. In this case the certificate of the Circuit Court of Appeals shows that certain classes of bonds received in the reorganization some preferred stock, and/or some common stock. The certificate also shows that old preferred and common stockholders were entitled to receive prior lien mortgage bonds, adjustment mortgage bonds and common stock in the amounts stated on payment of assessments of $20 and $25, respectively. Stockholders could not receive any securities unless they paid the assessments and purchased the group of securities offered to them. On the appellants' theory that unsecured creditors must receive securities of higher rank

than any securities sold to stockholders, it must be equally true that secured creditors must receive securities of higher rank than those offered to unsecured creditors. Obviously, since the secured creditors in some cases received common stock and the stockholders were allowed to purchase bonds, no offer to unsecured creditors could be made which would comply with the appellants' theory. In other words, no reorganization in which bondholders accept common stock could be consummated on the appellants' theory, unless unsecured creditors were paid in full. Yet it is most desirable in many cases to have bondholders accept stock for part of their claims.

The appellants have consistently disregarded the fact that the offer in the reorganization to certain classes of bondholders was only a very little better than the offer made to unsecured creditors, that is to say, they disregard the fact that the unsecured creditors would have received nothing unless the bondholders were willing to make concessions, and that the fairness of the offer to creditors depends not only on the amount offered to stockholders, but also on the amount accepted by bondholders.

What the secured creditors having liens of various ranks and priorities give up in order to bring about reorganizations in the interest of all concerned, as well as what the old stockholders are assessed, manifestly is for the benefit of and not in anywise at the expense of unsecured creditors. All the cases recognize the fact that except for the voluntary surrender by the bondholders of parts of their legal rights and the voluntary payment of assess-

ments on the stockholders, the unsecured creditors as a rule would receive nothing.

In Fletcher, Cyclopedia Corporations, Volume 7, Section 4950, that author says:

> "If the rights secured to the stockholders are at the expense of the bondholders and not of the unsecured creditors the latter cannot complain."

Practically all of the cases recognize that fresh or new money is essential to any plan of reorganization and as a general rule this money can only be raised through an assessment upon the old stockholders.

In the case of Walsh Tie and Timber Company v. Missouri Pacific Railway Company, 280 Fed. 38, the Circuit Court of Appeals for the Eighth Circuit said:

> "The acceptance of the plan by the holders of mortgage bonds in excess of $60,000,000, superior in right to the claims of general creditors, and the surrender of those bonds for convertible 5 per cent preferred stock, par for par, is a powerful refutation of the contention that general creditors were not fairly and equitably treated. The Court gave full and careful consideration to the reorganization plan and appellants' objections, and in approving the former and overruling the latter said:
>
> > " 'The general creditors have been treated very, very fairly indeed.' "

The assessment on the old stockholders and the requirement that they purchase certain bonds at par regardless

of their market value was a burden rather than a benefit and was the condition on which the stockholders were allowed to retain an interest in the new company (Guaranty Trust Co. of New York v. Missouri Pacific R. R. Co., 238 Fed. 812, at page 818).

In Volume 7, Fletcher, Cyclopedia Corporations, Section 4950, it is said:

> "An assessment upon the common stock may take the form of requiring stockholders to pay in cash a certain per cent of the par of their holdings for which they are to receive new bonds at par carrying a low rate of interest and being inferior liens, since in such a case it is doubtful whether the bonds will ever be worth par, and, hence, it operates as an assessment upon the common stock to the amount of the discount."

The appellants' theory also completely disregards the possibility that an offer made in preferred stock or income bonds to unsecured creditors might well be of less value than an offer made in common stock. It would have been entirely possible in this reorganization to offer to unsecured creditors income bonds or preferred stock bearing a low rate of interest or dividend which would have had a value less than the value of the securities which they were offered. This would have been a strict compliance with the suggestion or dictum in the **Boyd** case and yet the appellants doubtless would not have been any better satisfied with that offer than they were with the offer which they received. Obviously, however, if the

offer had been in that form, the Circuit Court of Appeals, since its only hesitation arose from the suggestion or dictum in the **Boyd** case, would have held it a fair and reasonable offer. If the suggestion or dictum of the **Boyd** case should now be changed into a fixed rule of law, reorganizations might well become substantially impossible. We submit, however, it is not a dictum of this Court, but only a suggestion, and not an exclusive one. This is particularly true now in respect of railroad reorganizations, for, since the passage of the Transportation Act of 1920, the Interstate Commerce Commission passes not only on the aggregate amount of securities which may be issued in a railroad reorganization, but also on the character of such securities, and requires that the amount of bonds and preferred stock issued should be well within the value of the properties and that the interest or dividends thereon should be within the probable earning power of the properties. If creditors must in every case be paid in cash or given preferred stock or income bonds, either reorganizations will become impossible or bondholders will be forced to make disproportionate sacrifices. In other words, unsecured creditors will be preferred over secured creditors, and the whole theory of the **Boyd** case will be upset.

It thus seems clear that any measure of a fair offer based on the character of securities offered is illogical and disregards the substantial questions involved. Value of securities and of property is and must be the true test.

The certificate shows that the appellants originally intervened in these reorganization proceedings for the purpose of compelling the new company to assume cer-

tain terminal contracts which they claimed were entitled to priority over the foreclosed mortgages and were covenants running with the railroad. When these contentions were not sustained by the Circuit Court of Appeals and this Court refused to review the decision of the Circuit Court of Appeals, the appellants attempted to secure substantially the same result by a claim that no fair offer could be made to them, except an offer to assume the terminal contracts. This was simply an attempt to reargue in another form a question already *res adjudicata*. The appellants are now attempting to bolster up this contention by an endeavor to get more money for whatever claims they may have against the old company because of the failure of the new company to adopt the Terminal contracts. That is really all that is involved in this case.

It may be mentioned in passing that the appellants devote some space in their brief to a discussion of the assessment on the stockholders, reaching the conclusion that the stockholders practically received their new common stock free of charge, since they were given bonds to a full principal amount equal to the amount of cash they were required to pay, and thus put into the property nothing which they did not immediately take back for themselves. The stockholders were not given anything. They not only surrendered their old stocks, preferred and common, as part consideration for new common, but were required to pay assessments for which they were entitled to receive certain bonds at par. We do not argue that this case is taken out of the principle of the **Boyd**

case, because securities were sold to the stockholders and nothing given to them. We do argue, however, that, as pointed out in all the cases, the new or fresh money necessary in all reorganizations can be raised as a rule only from the stockholders and cheaper from them than from anyone else; that if this money is not so raised there can be no reorganizations and the creditors will receive little or nothing; that the amount of securities which the stockholders were required to take at par must be calculated so as to give only such reasonable opportunity of profit as will induce stockholders to put in the necessary new money—it being generally true that the bonds which the stockholders receive have a value substantially less than their face amount. The stockholders actually contribute money to the property which they cannot get back until the maturity of their bonds and which in the meantime is earning a return for the benefit of all security holders, including unsecured creditors who accept the offer.

(c) **The Effect of an Assessment on Creditors.**

We have pointed out above that since the offer to unsecured creditors in this reorganization was made in the alternative, the answer to the third question of the Circuit Court of Appeals, in so far as it involves the question of payment by unsecured creditors, is immaterial. It was not the **only** offer. The creditors had a choice of offers. We believe, however, that an offer to unsecured creditors in the form of an option to purchase securities of the new company might well be under proper circumstances a fair and reasonable offer, when, as here, it is

admitted to be better than the corresponding offer to stockholders.

One of the reasons, we repeat, why the courts recognize the propriety of permitting stockholders to participate in a reorganization is the necessity of raising new money for the reorganized property by assessment on stockholders. The courts also recognize that the secured creditors may, if they so desire and if the property is not worth more than the amount of secured debt, take all the property to themselves and exclude both unsecured creditors and stockholders. If, therefore, in a reorganization the property reorganized is worth no more or little more than the amount of secured debt thereon, so that unsecured creditors could not hope to receive anything except through a reorganization plan, and if the amount of new money required is so large that it is impracticable to raise it all from stockholders, unsecured creditors should not be heard to object if they, as well as the stockholders, are given an opportunity to subscribe for new securities of the reorganized company, but on better terms than stockholders may do so. It would, of course, be essential that if the value of the securities sold to stockholders is in excess of the amount they are required to pay therefor so that stockholders reserve some interest in the new company, the securities sold to creditors should be worth a greater amount in excess of the price paid therefor, the amount of the differential in favor of creditors as against stockholders depending on the relation of the value of the mortgaged property to the se-

cured debt. In the instant case, not only was there a differential in favor of creditors, because of the lower price at which the securities were offered, but the creditor was also favored by the fact that the amount of new securities which he was allowed to purchase was based on interest on his claim as well as on principal. If the opportunity given to stockholders to purchase certain securities by way of assessment was of any value (i. e., if the stockholders received anything) the option given creditors to purchase the same securities for substantially less was more valuable. The Certificate of the Circuit Court of Appeals gives no facts as to the value of the reorganized property in this case or as to the amount of the secured debt thereon, so that there is not and cannot be before this Court the question whether the specific offer (known as offer B) made to unsecured creditors in this case would have been a fair and reasonable offer if there had been no alternative offer.

POINT II.

There is no basis in the decisions or in the principles of equity for the contention that this Court should establish a fixed formula by which all cases of this nature can be decided.

The appellants, in their brief in this court, have practically abandoned any attempt to support the literal acceptance of the suggestion or dictum in the **Boyd** case on a practical and logical basis, and devote the greater part

of their brief to a plea that this Court should establish a formula by which all offers to creditors may be tested, such formula to be "preferred stock or income bonds." For obvious reasons they prefer to call this suggested rule-of-thumb a "fixed principle" rather than a formula. The contention is based on a misapplication of the principles of equity and a misconception of the **Boyd** case and its relation to the general body of law.

The **Boyd** case decided one point and only one. That point was that in a reorganization carried out by foreclosure of mortgages in pursuance of a reorganization plan in which stockholders participate, a creditor may follow into the hands of the new corporation the property of his former debtor unless he is offered the opportunity to participate in the reorganization on equitable terms. This is a general equitable exception to the common legal rule that a mortgagee may purchase property at foreclosure sale and may thereafter dispose of the property so purchased in such manner as he wishes, cutting off junior liens and interests. It is not derived from the rule that a mortgagor may not buy in at his own mortgage sale and cut off intervening rights, but is a separate and distinct equitable principle, an example of equity's power to make exceptions to legal rules in order to secure equity. It is based on the magnitude of large corporate enterprises and on the fact that a large corporate property cannot under normal circumstances be expected to bring at foreclosure sale a price commensurate with its value, because

the amount required to be paid is so large that ordinarily no one but the old security holders can bid at the sale.

There is no shadow of intimation in the cases to support the contention of the appellants that the suggestion of the **Boyd** case requiring a fair offer is a special exception applicable only in railroad cases to a general rule that creditors must be paid in full in cash if stockholders are to be given anything at all on reorganization. In the **Boyd** case itself no offer had been made, and none had been made in the **Monon** case or the **Guardian Trust Company** case, nor has this Court had occasion to pass on any case in which an offer had been made. The District and Circuit Courts have been unanimous in treating the rule as one single rule rather than a rule and an exception.

Still less is there any reason to limit the application of the so-called "exception" to railroad reorganizations. The language of this Court in the Boyd case refers in broad terms to all reorganizations. It is true that all of the cases before this Court and most of the cases in which these questions have arisen have been cases of railroad reorganization, because until recently there were few industrial reorganizations of sufficient magniture to raise similar questions. In **Howard v. Maxwell Motor Company,** 269 Fed. 292, however, the Court treated the entire rule as applicable to an industrial reorganization, and in **Mountain States Power Company v. Jordan Lumber Company,** 293 Fed. 502, to a public utility reorganization. Nowhere in the cases is there any indication that a "fair

and reasonable" offer to creditors in an industrial reorganization will not protect the new company as fully as in a railroad reorganization.

The appellants desire to limit to railroad reorganizations at least that portion of the doctrine which they treat as the exception (i. e., the right to cut off a creditor by making him a fair offer of participation), because they wish to analogize this part of the doctrine to the cases of so-called "six months claims" and displacement of liens by receiver's certificates in which they claim fixed rules have been laid down, and to argue that there must be a formula by which the rights of creditors may be measured. In support of their contention for a formula they cite the language of Mr. Justice Lamar in the **Boyd** case, to the effect that the right of a creditor to go against the new company is not dependent upon the value of the property of the old company, but must be determined by an absolute rule. They also cite various statements by eminent jurists and text writers to the effect that equity decides cases on fixed principles. From these statements they argue that the question of the rights of creditors in railroad reorganizations must be reduced to a formula so as to avoid the danger of leaving each case to be decided in the sound judicial discretion of the Chancellor. This argument of the appellants disregards the great distinction between a fixed principle and a formula. Neither the statements quoted in their brief nor the language of Mr. Justice Lamar above referred to constitute any authority for the adoption of a formula.

The courts have never fixed a rigid rule as to what claims may be preferred over mortgage indebtedness.

In Tardy's Smith on Receivers, Volume I, at page 1144, that author states:

> "An attempt to state a general rule sufficiently definite as to the class of creditors that would be so preferred and the fund from which they would be paid to furnish an accurate guide for saying in advance what the decision of a court would be in any given case would certainly not be without difficulty. Perhaps the best that can be said about this point is, as was said in the first case (Fosdick v. Schall, 99 U. S. 235), in which the United States Supreme Court entered an opinion on the subject, that: 'No fixed and inflexible rule can be laid down for the government of courts in all cases. Each case will necessarily have its own peculiarities which must to a greater or less extent influence the Court when he comes to act.' "

In Volume 33, Cyclopedia of Law and Procedure, at page 536, it is said:

> "In respect to debts incurred before a receiver was appointed, in order that they may be entitled to priority within the meaning of the above rule, they must have been incurred within a reasonable time before the receiver was appointed and left unpaid because of the sudden action of the Court in making such appointment. The determination of this period is ordinarily within the sound discretion of the Court having jurisdiction of the accounts, and has usually been fixed at six months before the appointment of the receiver, although as to such debts there is no arbi-

trary six months' rule, and the equities of the case may be such that a claim will be allowed preference if incurred within a year, or even for a longer period, as where the services are rendered or supplies furnished under a continuous contract, or where the delay in enforcing payment was not caused by the creditor."

One reason that in the earlier cases six months was generally fixed as approximating the time in which preference claims must accrue was, that there is usually an interval of six months between the dates when installments of interest upon bonds fall due (Westinghouse Air Brake Co. v. Kansas City Southern Railway Co., 137 Fed. 26).

In 22 Ruling Case Law, page 1137, it is said:

"But notwithstanding what is said in some cases, concerning the time within which a claim must have been contracted, before the appointment of the receiver, and within which, if it is a preferred claim, it may be enforced, there is no fixed rule upon the subject. The allowance of preferred claims, in equity, against the property of a railway company in the hands of a receiver does not depend upon any fixed or arbitrary rule as to the time when the debts were contracted; further than that, they must have been contracted within a reasonable time before the appointment of the receiver, such reasonable time depending upon the circumstances of each particular case."

The following are some of the cases in which preference has been allowed to claims older than six months:

Southern Ry. Co. v. Carnegie Steel Co., 176 U. S. 257, 44 L. Ed. 458, 20 Sup. Ct. 347, 8 to 11 months;

Hale v. Frost, 99 U. S. 389, 25 L. Ed. 419, 33 months;

Burnham v. Bowen, 111 U. S. 776, 28 L. Ed. 596, 4 Sup. Ct. 675, 11 months;

Virginia & A. etc. Co. v. Central R. R. etc. Co., 170 U. S. 355, 42 L. Ed. 1068, 18 Sup. Ct. 657, 8 months;

Central Trust Co. v. St. Louis etc. Ry. Co., 41 Fed. 551, 1 year;

Farmers' Loan & T. Co. v. Kansas City etc. Ry. Co., 53 Fed. 182, 18 months.

So that it is clear that opposing counsel gain nothing by analogy or otherwise from their argument with respect to such matters, as no fixed and arbitrary rules have been prescribed. On the contrary, certain general principles have been applied to the facts of each case. All the analogies are against appellants. Nor do opposing counsel gain anything by their reference to the decisions of the courts with respect to the issuance of receiver's certificates. The courts have not laid down any general or inflexible rules with respect to the purposes for which receiver's certificates may be issued, or in just what cases they may be given priority over mortgage or other indebtedness, but every case has been decided on its peculiar facts by the application of general equitable princi-

ples rather than fixed and arbitrary rules. In 23 Ruling Case Law, p. 91, it is said, "questions of priority are not governed by any fixed and inflexible rule," and the same is true with respect to purposes for which they may be issued (Id. p. 95). Here again the analogies are against appellants.

The **Boyd** case itself must be taken in its setting. Somewhat over-simplified and too symmetrical is the scheme of appellants' argument in explaining it as merely a reminder to the lower courts of the principle decided in Howard v. The Railroad Company. When this Court extended the principle of the **Howard** and **Monon** cases to the facts of the **Boyd** case it recognized the gravity of the step. This appears not only from the vigor and weight of the dissenting minority, but perhaps even more clearly from the degree in which the majority were at pains by suggestion, illustration and dictum unnecessary to the decision itself to indicate how narrow its limits were and how wide a field it left untouched. The decision fixed indeed the general principle that even where there is foreclosure creditors may not be ignored and frozen out **without an offer** while stockholders are recognized. But this Court did not attempt to decide future cases in which there might be an offer. Yet appellants attempt to erect the illustration given by the Court

to allay the fears of counsel regarding future reorganizations into a fixed formula to be applied to all cases, mechanically and regardless of the facts. Clearly it could not have been the intention of the Court to legislate for future cases.

In the **Boyd** case no contention apparently was made that the value of the property after providing for the mortgaged debt was insufficient to pay the unmortgaged debt and accordingly this Court did not decide that the creditor's right to go against the new company was independent of the value of the property. Mr. Justice Lurton, in the dissenting opinion in the **Boyd** case, concurred in by three other Justices, clearly stated the principle by which the creditor's rights should be measured, when he said at page 511:

> "That corporate property must be applied to corporate debts before stockholders can participate, is plain. But I think every case should stand upon its own facts, and the remedy be shaped to do justice and equity in the particular case, and not tried out by any hard and fast rule such as indicated when this Court says that the invalidity of a judicial sale must turn upon the character of the reorganization agreement and is not affected by actual consequences to creditors."

In the **Guardian Trust Company** case this Court specifically announced the principle that creditors' rights depend upon the value of the property. At page 176 of

the opinion in that case this Court, among other things, said:

> "As the claim of the trust company was put by the Court of Appeals upon the equitable right of creditors to be preferred to stockholders against the property of a debtor corporation, it is essential to inquire whether the appellant received any such property, that is, whether it got by the foreclosure more than enough to satisfy the mortgage which was a paramount lien. * * * Therefore, the $4,750,000 of that stock given for the Belt Company's stock was worth at least $475,000.00 and probably more, but the value of this stock depended on the value of the Belt Company's property above the mortgage."

Obviously, this is the only equitable principle since there is no reason why a creditor should be entitled to get more as a result of a reorganization than he would have gotten if there had been no reorganization. A rule which permits the creditor to recover from the new company, irrespective of the value of the property turned over to it, in effect imposes punitive damages on the stockholders, although the **Boyd** case clearly states that its decision is not based on any fraud or illegality or evil doing of any sort on the part of the reorganizers. Every case which has been decided since the **Boyd** case has by its language restricted the creditor's rights to the value of the property, in other words, has simply preserved his rights without adding to them. This point was expressly decided by the Court of Appeals for the Ninth Circuit in

Mountain States Power Company v. Jordan Lumber Company, supra.

Of course, the value of the property in this case is not in issue in answering the questions certified by the Circuit Court of Appeals. The foregoing, however, illustrates not only that there is no formula, as asserted by the appellants, for determining the extent of a creditor's rights, but that there could be no such formula as the appellants suggest without violation of all equitable principles. Similarly, there can be no formula to determine what offer of participation must be made to a creditor. Admittedly, equity acts in accordance with fixed principles, the fixed principle in this case being that a creditor cannot be cut off by foreclosure proceedings in which stockholders are interested unless he is given an equitable participation, but to hamper the workings of equity by a formula is entirely contrary to all principles on which equitable doctrines have developed.

The great purpose of equity is to mitigate the harshness of legal rules and to substitute therefor a flexible body of jurisprudence whose decrees can be molded to meet the exigencies of the situation presented, that is, as Mr. Justice Lurton said in the **Boyd** case, "shaped to do justice and equity in the particular case." Every attempt to codify into strict rules the principles of equity jurisprudence defeats at the outset the purpose desired to be achieved, since no one can draw a formula which will meet all situations which may arise.

Counsel for appellants (pages 41, 50 and 51) quote excerpts from a monograph on reorganization by Mr. Paul D. Cravath, a lawyer of preeminent standing and an acknowledged authority on matters pertaining to corporate reorganizations. We respectfully submit, however, that none of the excerpts in any way support the contentions of opposing counsel nor in any of the excerpts is any such rule announced as that contended for by them. In all fairness, we think it is but proper to state the fact, which will not be denied by opposing counsel, that Mr. Cravath's firm were counsel for the Reorganization Managers in the instant case and approved the offer to unsecured creditors.

Counsel for appellants have gone outside of the substantive and ultimate facts as set forth in the certificate in their discussion of the value of the securities. They even ask this Court to take judicial notice of the current market prices of some of them, although at page 58 they admit the certificate does not state the market prices of securities at any time and that they would probably fluctuate widely from one date to another and that comparisons would differ according to the dates selected for comparison. The questions as certified show upon their face that the court below was and is of the opinion that on the facts the offer was and is fair and reasonable. No question with respect to the value of the securities was certified. Only three questions of **law** were certified. The whole case was not and could not be certified.

The appellants are asking this Court to lay down as an invariable formula that creditors must in every reorgani-

zation in which stockholders participate be given preferred stock or income bonds. A moment's reflection will show the impracticability of any such fixed rule. Suppose, for example, the corporation being reorganized is in such bad condition that bondholders must consent to take preferred stock or common stock, as indeed some bondholders did for part of their claims in the present case. Must unsecured creditors still receive preferred stock or income bonds? Moreover, if there is to be a formula, should it not be a complete formula, that is, should not this Court lay down a rule fixing the amount of preferred stock or income bonds to be given for every $100.00 of the creditors' claim, and fixing the rate of interest or dividends which should be borne by the preferred stock or income bonds to be offered? There is no reason why the character of the security should be specified and not the terms on which it is to be issued. Obviously, many reorganizations will be rendered impossible if the reorganizers start out with the requirement that unsecured creditors must receive a specified amount of preferred stock or income bonds bearing a specified rate of interest or dividends. This is especially true in a railroad reorganization where the Interstate Commerce Commission must approve the issue of the new securities. If any such fixed rule is to be established, either mortgage bondholders would have to cut down the amount of securities which they would receive, thus preferring unsecured creditors over secured creditors, or it would be impossible to raise the necessary money by assessment on the stockholders,

which this Court has recognized as a customary and proper method of raising the new money necessary in a reorganization. Moreover, if a creditor is to be entitled to recognition of his full claim, irrespective of the value of the property in question, any such formula would in many cases give an unsecured creditor an inequitable preference by giving him a participation much greater than that to which he is entitled. Equity regards the substance and not the form, and will not, by laying down a formula, substitute for a real determination of the equities of a situation, an inflexible and procrustean judicial measuring rod which, though easy to apply, defeats the very purpose for which it is made.

The appellants contend not only that there should be a formula, but that the formula should specify preferred stock or income bonds, and require that creditors in all cases be given securities prior in rank to any securities offered or sold to stockholders. They justify this claim by saying that a creditor has a right to have securities which, although not bound to be paid at all, must in any event be paid before the stockholder receives anything.

This contention may sound well in theory, but has no basis in fact. It is not even justified by the suggestion or dictum in the **Boyd** case, for in the **Boyd** case preferred stockholders were given new preferred stock, and a literal compliance with the suggestion or dictum would not have given creditors any assurance that they would receive their money before stockholders received anything.

The actual value of an offer made to creditors depends, in fact, not on the prior rank of the securities which they receive, but on the value of such securities. The creditors do not expect to receive money for their securities by having them paid off. Income bonds may mature fifty or one hundred years after their date of issue, and preferred stock will never be paid off by the company unless it is redeemed. The actual way in which creditors receive their money is through the value of their securities in the market. Income bonds may well be worth less than preferred stock and preferred stock may well be worth less than common stock. It all depends on the interest or dividend rate paid on the bonds and stock, the relative rights and disabilities of preferred and common stock and on the success of the company's operations. Any formula based on priority in rank disregards substance in favor of form.

All this shows that any attempt to lay down a formula is impossible, and that each case must be decided on all its own facts, taking into account the value of the property and the value of the new securities offered. The appellants foresee direful results if these matters are left in each case to the sound judicial discretion of the Chancellor, but the questions are, as above pointed out, questions of fact and of equity, not of law, and can only be properly decided by the Chancellor familiar with all the facts. If the Chancellor decides them improperly, there is always the right of appeal to the Circuit Court of Appeals, and

the right to a review by this Court if this Court will grant certiorari.

* * * * * * *

The appellants have devoted some space in their brief to a discussion of the effect of the allowance of interest on the fairness of the offer made to unsecured creditors. This question goes only to the fairness of the offer in fact and has no bearing whatsoever on the answers to the questions certified to this Court. We, however, believe that the appellants have misconceived the law on this point.

It clearly appears from the certificate that in all cases the par amount of new securities offered (taking the non-par value stock at $100 per share) plus the cash offered, if any, equaled and in no case exceeded the principal amount of the old outstanding securities in respect of which the offer was made, plus unpaid interest up to January 1, 1922; that the offer to unsecured creditors included interest up to the same date, whereas the Receiver was appointed and took possession of the property on September 27, 1915, and that in all cases new prior lien bonds and adjustment bonds, whether offered to secured creditors, unsecured creditors or stockholders, also bore interest from the same date—January 1, 1922. In this way the unsecured creditors were placed on a plane of equality with secured creditors and thereby further preferred, not only as against secured creditors, but as against old stockholders.

It also appears from the certificate that in all cases new Prior Lien bonds and new Adjustment bonds, whether offered to secured creditors, unsecured creditors or stockholders, also bore interest from January 1, 1922.

In the brief of appellant it is claimed that it is well settled that as against the stockholder the creditor is entitled to the payment of his claim in full with interest. No cases are cited to this effect, but a part of Section 598 (p. 1678), Vol. II, Tardy's Smith on Receivers, is quoted and relied upon as establishing the contention made. Neither that part of the section quoted nor the cases cited by this author support their contention. It is true that in some receivership cases where there were sufficient funds to do so interest has been allowed on some classes of claims, such as supply claims.

In the part of the section quoted it is specifically stated:

> "All creditors are entitled to be paid in full with interest to the time of payment and will be so paid **'if the funds are sufficient.'** "

This same author, further along in the same section, states:

> "As against one another, however, interest is not allowed to members of a class if the class fund is not sufficient to allow interest to all; thus general unsecured creditors, whether their claims bear interest by contract or simply by way of damage for delay in payment, **are not allowed interest in case of in-**

solvency. It is with reference to this last class of creditors that the rule is usually stated to be the general rule."

From the certificate it appears that the properties were sold under final decree, and it does not appear that there were sufficient funds to pay claims of any class, much less unsecured creditors, in full. On the contrary, all classes were offered new securities. Only with respect to five issues out of eighteen of securities was cash offered in part. The old company was hopelessly insolvent.

In Volume I of Clark on the Law of Receivers, Section 867, the rule is stated thus:

> "The general rule is that interest is not allowed after property of the insolvent is in custodia legis. This rule is not based on loss of interest-bearing quality, but it is a necessary and enforced rule incident to equality of distribution between creditors of assets, which in most cases are insufficient to pay all debts in full. Supply creditors to a railway who are preferred, and the fund for their payment is sufficient to pay them in full, may be allowed interest on their claims after the appointment. Lien claimants are generally entitled to interest.
>
> "After property of an insolvent passes into the hands of a receiver, or of an assignee in insolvency, interest is not allowed on the claims against the funds. The delay in distribution is the act of the law; it is a necessary incident to the settlement of the estates."

That the general rule is as we contend for it, and as stated by Judge Sanborn in his opinion (supra, p. 23),

as well as in the above authorities, is well settled by this Court (Thomas v. Western Car Company, 149 U. S. 95; American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry. Co., 233 U. S. 261).

In Thomas v. Western Car Company, supra, this Court said:

> "As a general rule, after property of an insolvent passes into the hands of a receiver or of an assignee in insolvency, interest is not allowed on the claims against the funds. The delay in distribution is the act of the law; it is a necessary incident to the settlement of the estate (Williams v. American Bank, 4 Met. 317, 323; Thomas v. Minot, 10 Gray 263). We see no reason in departing from this rule in a case like the present, where such a claim would be paid out of moneys that fall far short of paying the mortgage debt."

In American Iron & Steel Mfg. Co. v. Railroad, supra, this Court said it is "not because the claims had lost their interest-bearing quality during that period, but it is a necessary and enforced rule of distribution due to the fact that in case of receiverships **the assets are generally insufficient to pay debts in full.**" * * * "For that and like reasons **in case funds are not sufficient to pay claims of equal dignity, the distribution is made only on the basis of the principal of the debt.** But that rule did not prevent the running of the interest during the receivership; and if, as a result of good fortune or good manage-

ment, the estate proved **sufficient to discharge the claims in full**, interest as well as principal should be paid."

That this is the correct interpretation of the general rule laid down by this Court in the two cases above referred to is clearly shown in the following decisions:

Pennsylvania Steel Co. v. New York City Ry. Co., 216 Fed. 472;
Huff v. Bidwell, 218 Fed. 10;
New York Trust Company et al. v. Detroit T. & I. Ry. Co., 251 Fed. 519;
Pintsch Compressing Co. v. Buffalo Gas Co., 280 Fed. 830, at page 844;
Mercantile Trust Co. v. Tennessee Central Railroad Company, 286 Fed. 425;
Peter A. Frasse & Co. v. Hartford Automotive Parts Co., 300 Fed. 876.

The rule in Missouri is the same as that announced by this Court (Van Frank v. Missouri Pacific R. R. Co., 89 Mo. Appeal Reports 460).

There is nothing in the certificate which would take this case out of the general rule and Judge Sanborn's decision supra, page 23, shows that in his opinion the facts of the case with which, as administrative judge he was familiar, brought it within the general rule. Attention is also called to the fact that in Judge Sanborn's opinion approving the offer he said:

> "The amounts of the claims of the unsecured creditors in the St. Louis & San Francisco Railway reorganization and in the Missouri Pacific Railroad reorganization were fixed and allowed, and securities

of the new company were distributed to them upon that basis (interest to date of the appointment of the Receiver and not later), and it is probable that this was the basis used in the reorganization of the Chicago, Rock Island & Pacific Railroad Company."

Conclusion.

For all the reasons above set out, we submit that all three questions certified by the Circuit Court of Appeals should be answered in the affirmative.

Respectfully submitted,

JOSEPH M. BRYSON,

Solicitor for Missouri-Kansas-Texas Railroad Company, Appellee.

ARTHUR H. VAN BRUNT and
JOSEPH M. BRYSON,

Solicitors for Francis F. Randolph and Hugo W. Blumenthal, Appellees.

EDWARD CORNELL,
CHARLES E. HOTCHKISS and
EDWARD C. ELIOT,

Solicitors for Central Union Trust Company of New York, as Trustee under Consolidated Mortgage, and as Trustee under Trust Agreement, Appellee.

GELLER, ROLSTON & BLANC and
NAGEL & KIRBY,
Solicitors for The Farmers' Loan and Trust Company, as Trustee under Refunding Mortgage, and as Trustee under St. Louis Division Mortgage, Appellees.

HORNBLOWER, MILLER & GARRISON and
CHARLES W. BATES,
Solicitors for The New York Trust Company, as Trustee under General Mortgage, Appellee.

BOYLE & PRIEST,
Solicitors for B. F. Edwards, as Trustee under General Mortgage, Appellee.

WHITE & CASE and
GEORGE H. WILLIAMS,
Solicitors for Bankers Trust Company, as Trustee under Second Mortgage, Appellee.

MASTEN & NICHOLS and
LEE W. HAGERMAN,
Solicitors for Columbia Trust Company (now Irving Bank-Columbia Trust Company), as Trustee under the First Mortgage of The Missouri, Kansas & Eastern Ry. Co., Appellee.

RICHARDS, SMYTH & CONWAY and
CHARLES A. HOUTS,
Solicitors for Central Union Trust Company of New York, as Trustee under Second Mortgage of M. K. & E. Railway Co., Appellee.

KING, LANE & TRAFFORD and
GEORGE C. HITCHCOCK,

Solicitors for Central Union Trust Company of New York, as Trustee under First Extension Mortgage, Appellee.

CHARLES P. WILLIAMS,

Solicitor for The Farmers' Loan and Trust Company, as Trustee under S. W. Coal & Improvement Company First Mortgage, Appellee.

JOSEPH M. BRYSON,
ALBERT RATHBONE,
ARTHUR H. VAN BRUNT,
NICHOLAS KELLEY,
EDWARD CORNELL,
EDWARD C. ELIOT,
H. C. MCCOLLOM,
EDWARD H. BLANC,
ALLEN C. ORRICK,
W. W. MILLER,
CHARLES W. BATES,
GEORGE H. WILLIAMS,
ROBERTS WALKER,
PERRY D. TRAFFORD,
GEORGE C. HITCHCOCK,
Of Counsel.